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SUBJECT: VIETNAM: STATE OWNED ENTERPRISE REFORM

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¶1. (SBU) SUMMARY: Reform of the state-owned enterprise (SOE) sector is one of the primary pillars of Vietnam's reform efforts and ongoing transition to a market economy. Relying on a four-pronged strategy that includes increasing competition, hardening budget constraints, divesting "non-strategic" enterprises, and strengthening autonomy of remaining SOEs, Vietnam has decided to retain a leading, but diminished, position for SOEs. The GVN examined approaches to transformation of the state sector taken in Eastern Europe, the former Soviet Union, and China and clearly decided that it will reform slowly. Unfortunately, though, it is falling behind its own schedule. Resistance by vested interests threatens to delay not only SOE reform but also impede reform in other areas, including in trade liberalization and the banking sector. END SUMMARY.

REFORM STRATEGY

¶2. (U) In 1986, Vietnam's economy was composed only of state-owned enterprises (SOEs). Facing high unemployment rates, a growing supply of labor, and widespread poverty, Vietnam undertook a policy of reform called "doi moi." Among other aspects, Vietnam committed in this program to make the transition to a "socialist-oriented, market economy." Now, after 18 years, the state sector contributes around 40 percent of GDP, 38.7 percent of industrial output, and 39 percent of employment. The GVN's present approach to SOE reform maintains an important role for the state sector while at the same time deploying four strategies for reforming the operation of SOEs: 1) increasing competition in markets through trade liberalization and a more level playing field with the private sector; 2) hardening the budget constraint by limiting government subsidies and by introducing a ceiling on the growth of credit to SOEs; 3) divesting non-strategic enterprises; 4) strengthening autonomous decision-making and accountability in those SOEs remaining under state ownership.

¶3. (U) INCREASED COMPETITION: Increased competition, which should force SOEs to act more like commercial entities, is the first and most visible prong of the SOE reform program. Vietnam has committed to integrate into the global economy through agreements, such as the U.S.-Vietnam Bilateral Trade Agreement (BTA)(see ref A) and the ASEAN Free Trade Agreement (AFTA), programs with the World Bank and International Monetary Fund (IMF), and eventually membership in the World Trade Organization (WTO). (Note: The IMF program is currently stalled due to a disagreement over the IMF's requirement of an audit of the State Bank of Vietnam. End note). As part of its efforts toward international integration, Vietnam has pledged to liberalize trade and investment rules, lower tariffs, abolish most quantitative restrictions, and create a transparent rules-based regime. Implementing these key obligations is expected to increase dramatically competitive pressures on Vietnamese enterprises.

¶4. (U) The GVN has started to create a more level playing field not only between foreign and state-owned enterprises through the above agreements, but also with domestic private ones. Although SOEs are subject to a different corporate law from private domestic and foreign invested enterprises, a SOE law, which passed in November 2003 and will become effective in July 2004, will regulate only relations between the state and enterprises. Currently, operational matters are left to the Enterprise Law, which also covers domestic private firms. The GVN is, furthermore, discussing harmonizing all enterprise and investment laws (see ref B) and is drafting a competition law that would include the state sector. (Note: Key clauses in the current draft of the competition law allow the exemption of state-owned monopolies deemed to be in the public interest and may diminish the impact the competition law has on key SOEs. End

note). In this new, more equal environment, SOEs will have to become more commercially viable or vanish.

¶5. (U) SOE BUDGETS CONSTRAINTS: GVN attempts to harden the SOEs' budget constraints and eliminate directed lending (see septel) should make them more profitable or force them to declare bankruptcy. In reality, though, GVN fears about the potential effect on an enterprise's workers and vested interests have made it easier for SOEs to avoid declaring bankruptcy. Although many SOEs lose money, only 46 have actually been declared bankrupt while 124 have filed for bankruptcy since 1995. (Note: The Ministry of Finance estimates that around approximately 35 percent of SOEs are loss-making, 15 percent break even, and 50 percent make a profit even though it is unclear how profits and losses are calculated. End note). Still, the GVN has stated that it will dissolve insolvent, loss-making enterprises that are not "strategic". At the same time, it has committed to restructuring the debt and assets of those for which it "must" maintain ownership. Real proof, beyond GVN statements, regarding this prong of the SOE reform program remains elusive given the lack of transparency of SOE financial accounts.

¶6. (U) DIVESTITURE: Unlike in many former socialist economies where privatization of SOEs played a central role in transforming the state sector, Vietnam has taken a "go slow", decentralized approach to this aspect of its strategy, declaring its intention to retain a significant portion of its state sector. In April 2002, the GVN issued a decision laying out principles governing "divestiture", declaring that the state will "reorganize toward merger or dissolution," those SOEs not meeting criteria related to industry, size, profitability and modernity. At the same time, the Decision stated the GVN will retain full ownership in a wide range of areas deemed "strategic." (Note: Vietnam does not call this process privatization, instead referring to it as equitization, divestiture, or transformation. End note). A January 2003 Directive from the Prime Minister further explained that the GVN will retain at least 51 percent of shares on initial public offering of profitable state enterprises that have state capital of 5 billion VND (approximately 320,000 USD) or more.

¶7. (SBU) Under the present approach, each Ministry, Province, and General Corporation formulates its own timetable for the transformation of its SOEs, with plans compiled into a published roadmap containing names and timeframes. In 2003, the GVN began this undertaking by compiling the 104 divestiture plans drawn up by line ministries, provinces, and General Corporations (GCs) into a list of 2800 "transformations" for the 2003-2005 timeframe. Assembling these divestiture plans was designed to increase the "ownership" over the process from the point of view of the state agencies that "own" concerned SOEs, but it has made the process appear optional, rather than mandatory. It gives the impression that the determination not to transform a SOE could go uncontested, which seems to ensure that SOEs with entrenched interests, regardless of whether or not they are "strategic" or profitable, will never be equitized.

¶8. (SBU) Within the international community, concern not only exists about the pace of SOE reform, but also its scope. With the majority of SOEs, including the large General Corporations, slated for "restructuring" rather than divestiture, it appears that some key officials in the political leadership and GVN continue to entertain unrealistic expectations that SOEs can be successfully restructured and re-emerge as highly-competitive conglomerates in an integrated economy. Although some may succeed, most will probably fail due to entrenched weaknesses. Such an outcome will damage the financial sector (where state-owned banks have provided extensive loans to SOEs) and the economy as a whole, as well as possibly impede trade liberalization efforts if the GVN believes that it must protect these weaker SOEs at the expense of moving forward with its international obligations.

¶9. (U) ACCOUNTABILITY AND AUTONOMY: The GVN recently addressed the issue of SOE accountability through a Prime Ministerial Decision. Outlining various criteria related to financial, business, and social factors, the Decision states that the GVN will use this information to evaluate the operational efficiency of each SOE and its "owner." The results of these assessments are to serve as a basis for making decisions on the future of SOEs and their management. At the same time, the GVN is attempting to increase SOE autonomy by separating state management from business monitoring. It is thus planning to create the State Financial Investment Corporation, which will be fully responsible for investing state capital in order to make a profit. In addition, this body is supposed to manage GVN investments in SOEs, leaving state agencies to be engaged only in state management issues. Although such efforts should encourage SOEs to act more like commercially oriented

entities, it is too soon to evaluate their effectiveness.

OTHER ISSUES

¶10. (U) FOREIGN PARTICIPATION: Under a March 2003 Prime Ministerial Decision, anyone, including foreign organizations and individuals, can buy shares of equitized enterprises. However, foreigners can only buy up to thirty percent of the charter capital. In addition, the Ministry of Finance established priorities regarding to whom shares should be sold, giving preference to outside investors with technology, market access, and managerial skills. Interested foreigners can buy unsold shares through an auction. Supporters of the stock market were disappointed that the GVN did not allocate this role exclusively to the stock market; rather the GVN only allowed that it was one of the possible vehicles for auctioning shares.

¶11. (U) VALUATION: Enterprise valuation determines share structure. 2002 guidelines on this issue require the appraisals to be based on the enterprises' financial accounts at the time of equitization, the quantity and quality of assets, the assets' specification and market price, value of the land use rights, and value of the business goodwill. If a company supplies services, it is to be valued using discounted cash flow methods.

¶12. (U) REDUNDANT WORKERS: In Vietnam, significant concern has centered on the future of workers that are likely to be made redundant by SOE reform. Therefore, the government established a social safety net fund for this group in April ¶2002. The account provides compensation in addition to the amount prescribed by the Labor Code for those redundant workers who began their employment before April 1998 or are on contracts from 1 to 3 years. After much debate between the GVN and international donors, it was determined that each redundant worker can receive six months of salary, six months of training, and a lump sum. Redundancy payments are said to average about 1,000 USD. (Note: This is about 2.5 times average GDP per capita. End note). The fund additionally covers any shortfall in enterprise obligations. Because SOE directors are considered public servants, rather than enterprise employees, they are not entitled to such compensation.

AFTER EQUITIZATION

¶13. (U) In 2002, the World Bank and the Vietnamese Central Institute for Economic Management undertook a study of 422 enterprises equitized prior to 2001. This review reveals the relative success of these enterprises, with sales growing at almost 20 percent per year, employment, at 4 percent, wages, at 12 percent, and assets, at 21 percent. Furthermore, over 70 percent of respondents indicated that they considered the enterprise to be performing better after equitization. Such positive results are partially attributable to the self-selecting approach taken to equitization, because those who anticipated commercial success chose to equitize first. Still, equitized enterprises did experience problems. Many are similar to those that other private sector counterparts encounter, including difficulties accessing credit from banks and obtaining government licenses and permits.

THE NUMBERS

¶14. (U) Vietnam began addressing the issue of the state sector in 1990 when around 12,000 SOEs existed. Since 1998, the GVN further reduced this number from over 6000 to approximately 4900 SOEs through liquidation, transformation, and mergers. Unfortunately, this decline has slowed down over recent years. Whereas in 1999, 370 SOEs were "transformed", the first ten months of 2003 only saw 213. (Note: These numbers include "equitizations", transfers, sales, liquidations, and bankruptcies. End note). It is clear that the GVN did not approach the roadmap's ambitious target of 1459 transformations in 2003.

¶15. (U) In mid-2001, the process of creating new SOEs almost came to a halt when the GVN instituted a requirement that the Prime Minister approve the creation of every new SOE. This change was ratified in 2002, creating strict controls over the creation of additional SOEs. The expectation by the World Bank and IMF was that the new policy would freeze all new SOEs; it did not. In fact, eight new SOEs came into existence in the first nine months of 2002. (Note: According to the World Bank, only 30 to 40 percent of SOEs created in 1998-2001 represented new state activities. End note).

¶16. (U) Most transformed enterprises are small, with the average number of employees about 250, and almost 85 percent having chartered capital of less than VND 10 billion

(approximately 640,000 USD). Furthermore, they generally had carried an average of about 370,000 USD in debt prior to transformation. The reduction in the number of smaller SOEs and the development of the larger, more successful ones means that the absolute size of the state sector has actually increased. This fact explains why the state sector's share of total GDP has remained consistent at around forty percent for the last five years. Meanwhile, the SOE share of industrial output has declined considerably due to the private sector's simultaneous rapid growth.

¶17. (U) Debt levels in SOEs continue to cause serious concern. The outstanding bank debt of SOEs amounts to approximately 6 billion USD, representing approximately forty percent of total domestic credit. Although the share of credit going to SOEs is gradually declining, credit to SOEs as a fraction of total outstanding loans remains at between 40 and 60 percent. (Note: Because of the dubious quality of the banks' audited accounts, there is probably no definitive accounting. End note) Although non-state-owned commercial banks nearly halved their credit exposure to SOEs, state-owned commercial banks (SOCBs) exposure only moderately decreased and remains four times as high as that of other banks (see septel for more on the banking sector).

¶18. (SBU) COMMENT: After examining approaches to transforming the state sector taken in Eastern Europe, the former Soviet Union, and China, Vietnam made a conscious decision to undertake reform slowly, especially with respect to SOEs. However, it is presently not even meeting its own targets. Initially, the GVN could blame the lagging reform on technical issues, given the enormity of the scope and complexity of the job. Now that the GVN has laid a significant portion of the legislative foundation, recalcitrant vested interests in the SOEs themselves and their home Ministries are emerging as a strong impediment to reform. (Note: It has revised or issued 14 legal documents related to SOE reform since 2001. End note).

¶19. (SBU) COMMENT CONTINUED: The GVN started equitization with the easiest cases, leaving the difficult (and more politically sensitive) cases for later. It has repeatedly stated that uncompetitive SOEs will simply disappear through increased competition. However, the GVN appears to lack clear priorities regarding "strategic" sectors. Our concern is that delays in SOE reform could negatively impact the GVN's trade liberalization agenda as the government attempts to protect all sectors due to entrenched interests and fears over unemployment. The World Bank has argued that the GVN needs to take a conservative approach since a major "restructuring" fiasco early on would only serve to delay the program further. Now it is up to the GVN to address the hard cases and show its commitment to a complete SOE reform program.
PORTER